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Avoiding Common Franchising Pitfalls for Franchisees

A guide to assist franchisees in avoiding important, but commonly overlooked, areas of liability in franchising transactions.

MATTHEW J. KREUTZER
PARTNER
HOWARD & HOWARD ATTORNEYS PLLC

Matthew has spent more than 15 years working with individuals and companies on issues relating to the franchise relationship. He is experienced in all facets of franchise law, assisting both start-up and mature franchisors with developing, protecting and licensing their franchise and distribution systems, and counseling companies regarding the laws and regulations pertaining to franchising nationwide.

Parties can risk significant legal liability if they enter into an agreement without understanding whether their business transaction is regulated as a franchise. Franchises are regulated by the Federal Trade Commission (FTC) under the FTC's rule, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities (*16 C.F.R. §§ 436-437*) (Franchise Rule), and by the laws of some states. A failure to comply with the Franchise Rule can constitute an unfair or deceptive act or practice in violation of Section 5 of the FTC Act.

Under the Franchise Rule, the term "franchise" refers to a continuing commercial relationship that has each of the following three elements:

- **Trademark license.** The business involves the distribution of goods or services associated with the licensor's trademark or trade name.
- **Payment of a fee.** The licensor requires payment by the licensee for the right to operate the licensee's business.
- **Control or assistance.** The licensor exercises significant control over or provides significant assistance in the licensee's method of operation.

Determining whether a specific business arrangement is a franchise is not always easy. There has been a great deal of litigation regarding the application of each of the three elements. However, where all three elements are present in a business relationship, the relationship is considered a franchise regardless of the name assigned to it by the parties. Some states use a different definition for determining whether a franchise relationship exists. Therefore, applicable state law must be identified and understood before determining whether a business relationship is a franchise.

This article discusses select causes of disputes and other liabilities that franchisees commonly overlook when entering into franchise agreements or other transactions that implicate state or federal franchise laws. Prospective franchisees should take steps to identify and avoid potential problems that may arise in franchise arrangements, including by reviewing and understanding:

- Applicable federal and state franchise laws.
- The franchise disclosure document (FDD) provided by the franchisor.
- The types of fees charged in a typical franchise arrangement.
- The provisions of the franchise agreement.

FRANCHISE LAWS

While both federal and state laws apply to franchises, they are not exclusive of one another. For example, if state law applies to the transaction, federal law also applies.

The laws of more than one state can also apply to a transaction. For example, where a franchisor offers to a Maryland resident a franchise to be located in Virginia, both Maryland's Franchise Registration and Disclosure Law and Virginia's Retail Franchising Act apply to the transaction (see *Md. Code. Ann., Bus. Reg. § 14-203*; *Va. Code § 13.1-559*). In this example, the franchisor must be registered to sell franchises in both states.

There are three different types of laws that specifically pertain to franchising:

- Disclosure laws.
- Registration laws.
- Relationship laws.

Because all state laws do not have the same breadth or applicability, the parties (and, in particular, the franchisor) must identify and evaluate any applicable state disclosure, registration and relationship laws.

DISCLOSURE LAWS

Disclosure laws are pre-sale laws that govern the franchisor's conduct in making franchise sales. These laws:

- Require a franchisor to provide the prospective franchisee with its FDD within a specified time before requiring the franchisee to pay money or sign a binding franchise agreement.
- Specify the nature of the information that must be disclosed in the FDD.

All franchise transactions in the US are governed by the Franchise Rule. Some are also governed by state disclosure laws as found in these 15 states: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Of these states, all but Oregon also have registration laws.

Under federal and state law, a franchisor must update its FDD annually (typically within 90 to 120 days of the end of its fiscal year) with new information. If the information disclosed in the FDD changes materially before the end of the fiscal year, the franchisor must update the FDD when the material change occurs.

Disclosure laws may differ by state. For example, some states have broadly written disclosure laws, so that a franchisor must register if any of these circumstances exist:

- The prospective franchisee lives in the state.
- The prospective franchisee plans to open the franchised business in the state.
- The franchisor has a place of business in the state.

Some states instead have disclosure laws that apply to a more limited set of circumstances. Others do not have disclosure laws, but instead have business opportunity laws written broadly enough to apply to franchisors. Most business opportunity laws specifically exempt franchise offerings, but only if the franchisor complies with the disclosure requirements under the Franchise Rule. As a result, these business opportunity laws ensure that franchisors that sell franchises in the state comply with the Franchise Rule.

REGISTRATION LAWS

Like disclosure laws, registration laws are pre-sale laws. Fourteen states have registration laws and all states that have disclosure laws, with the exception of Oregon, also have registration laws. There is no federal registration law. As a result, franchisors that comply with the Franchise Rule's disclosure requirements can sell in states that do not require registration or a business opportunity exemption filing without having to file their FDD with any governmental authority.

Under most state registration laws a franchisor must:

- Register in the jurisdiction before offering to sell or selling franchises in the jurisdiction by filing its FDD, plus various application forms, with the jurisdiction's applicable regulatory agency.
- Update or renew its registration annually.

If a franchisor is not registered in the relevant jurisdiction, a franchisor typically cannot offer to sell or sell a franchise in that jurisdiction.

Registration laws differ by state and it is possible that more than one state's registration laws will apply to a given transaction. For example, some states have registration laws that are written broadly, so that a franchisor must register if either:

- The prospective franchisee lives in the state.
- The prospective franchisee plans to open the franchised business in the state.
- The franchisor has a place of business in the state.

Other states have registration laws that apply to a more limited set of circumstances.

RELATIONSHIP LAWS

Unlike disclosure and registration laws, relationship laws are post-sale laws that apply only after the franchisee has purchased the franchise and the parties have begun their contractual relationship.

While there is no federal franchise relationship law, these 22 states and two territories have laws that govern aspects of the franchise relationship: Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, Puerto Rico and the US Virgin Islands.

Relationship laws can govern a variety of post-sale conduct by the franchisor. Many relationship laws prohibit a franchisor from terminating or refusing to renew a franchisee unless the franchisor either fulfills specific conditions or offers to compensate the franchisee for the termination or non-renewal.

Relationship laws may also, for example:

- Prohibit discrimination or preferential treatment between similarly situated franchisees.
- Prevent a franchisor from restricting the venue for legal disputes between the parties to locations outside of the franchisee's home state.
- Prohibit a franchisor from terminating the franchise agreement unless the franchisor has given the franchisee notice and a statutorily mandated period to cure a default.

FRANCHISE DISCLOSURE DOCUMENT

Apart from the franchise agreement itself, the FDD is the most important document in an actual or potential franchise purchase transaction. The FDD contains several disclosures that explain the franchisor, its history and the franchise agreement itself. The FDD should not be ignored by any prospective franchisee.

The FTC enacted the Franchise Rule to protect franchisees from apparent and widespread unfair and deceptive practices by franchisors, such as:

- Material misrepresentations.
- Failure to disclose material facts.
- Unsubstantiated earnings claims.
- Failure to honor promised refund requests.

The Franchise Rule and some state laws require any franchisor that wants to offer a franchise in the US to:

- Provide an FDD to a prospective franchisee at least 14 calendar days before asking the prospective franchisee to pay any money or sign a binding agreement with the franchisor.
- Make in its FDD certain disclosures pertaining to the company, its officers, the expected initial investment, fees and other aspects of the franchise relationship.

AREAS OF DISCLOSURE

Each area of disclosure is referred to in the FDD as an "Item" and there are 23 different Items in the FDD. Significant areas of disclosure in the FDD include:

- Fee disclosures, for example:
  - initial fees, such as any fees that are paid to the franchisor or its affiliates before the franchisee opens the franchised business;
  - other fees, such as fees that are paid to or imposed by the franchisor or its affiliates during the life of the franchise; and
  - an estimate of the initial investment that is required for the franchisee to build, open and begin operating the franchise.
- The prior business experience of the franchisor, its affiliates and the officers, managers, directors and other key employees who have management responsibility relating to the franchise.
- The litigation and bankruptcy history of the franchisor and its officers, managers, directors and other key employees who have management responsibility relating to the franchise.
- Whether the franchisee is offered an exclusive territory and a description of any limitations on the scope of the franchisee's territorial rights, including any rights the franchisor retains in the franchisee's territory.
- A description of the types of initial and ongoing assistance, including a summary of training, that the franchisor agrees to provide to the franchisee.
- A list of any restrictions on the types of products, services, inventory items, equipment, real estate or other items that the franchisee must purchase from the franchisor, its affiliates or approved suppliers.
- The financial statements of the franchisor, which must be audited by an independent certified public accountant.
- A list of the existing franchised and company-owned units in the franchisor's national system and information regarding the history of those locations over the franchisor's previous three fiscal years.
- If the franchisor makes any projections or claims regarding the franchisee's potential earnings (financial performance representations), the franchisor must include in the FDD the financial performance representations and the material assumptions or bases for the projections or claims.

Search The Franchise Rule and its Disclosure Requirements for more on the areas of disclosure in the FDD.

FINANCIAL PERFORMANCE REPRESENTATIONS

Financial performance representations take a variety of forms and include any statement (express or implied) that promises that the prospective franchisee can achieve a specific financial goal under the franchise regarding:

- Potential sales.
- Income.
- Gross profits.
- Net profits.

The financial performance representations disclosure is the only disclosure that is optional for franchisors. A franchisor can choose not to make any financial performance representations, but if it does not include them, the franchisor:

- Must include a clear and conspicuous statement in the FDD that it has elected not to make that disclosure. The FTC included this requirement to help mitigate the common misstatement by franchisor salespeople that federal law prohibits franchisors from making financial performance representations.
- Is prohibited from making any statement, whether in the FDD or otherwise, about the sales, income or profits that the franchisee can expect to achieve, including implied earnings claims, such as claims that a franchisee will:
  - be able to replace its current income by working at the franchise;
  - earn enough money to buy a new sports car; or
  - earn a 100% return on investment within the first year of operation.

Mere puffery, however, such as "earn big money" or "this is the opportunity of a lifetime" generally does not constitute a financial performance representation.

If a franchisor does not make a financial performance representation in its FDD, prospective franchisees can ask existing and former franchisees in the system (listed under Item 20 of the franchisor's FDD) for information regarding their own historical performance. Franchisees are generally not subject to the same restrictions against sharing their own financial information as the franchisor.

TYPES OF FEES

Failure to understand transaction-specific fees or the typical fees that apply to franchise arrangements can lead to the franchisee paying more than it thought it had bargained for. For example, the franchisor may require the franchisee to periodically invest in expensive systems or services upgrades. It can also cause disagreement or litigation between the parties.

Most franchise agreements contain one or more of these three basic types of fee arrangements:

- Profit and administrative fees.
- Service fees.
- Expense reimbursement and cost recovery fees.

PROFIT AND ADMINISTRATIVE FEES

Profit and administrative fees:

- Give prospective franchisees the incentive to start and continue franchising.
- Set the franchisee's expectation that the franchisor will likely share in the income of the individual franchised business.
- Help pay for the franchisor's administrative infrastructure used to support its franchisees and franchise system.

There are three types of profit and administrative fees:

- Initial franchise fees.
- Royalty fees.
- Successor or transfer fees.

Initial Franchise Fees

Prospective franchisees pay initial franchise fees to the franchisor for the privilege of entering into the franchise relationship. Typically paid in a lump sum, the amount:

- Is usually large enough to signify the franchisee's commitment to build the business and learn the franchise system.
- May have some component of profit built in, but in most circumstances the franchisor uses the initial franchise fees to cover its costs to locate and train new franchisees.
- Usually helps new franchisors cover their significant start-up costs.

The amount of initial franchise fees is disclosed in Item 5 of the franchisor's FDD.

Royalty Fees

Royalty fees are typically ongoing fees that a franchisee must pay the franchisor during the life of the franchise relationship. Royalty fees are usually expressed as either or a combination of a:

- Percentage of the franchisee's gross revenue.
- Flat fee.

Royalty fees are usually paid weekly or monthly, but in rare instances are paid quarterly or annually. The amount of royalty fees is disclosed in Item 6 of the franchisor's FDD.

Successor or Transfer Fees

Under the franchise agreement, the franchisor typically reserves the right to assess either or both:

- **Successor fees.** These fees compensate the franchisor if and when the franchisee decides, at the end of its term, to continue in the franchise relationship, typically by entering into a successor franchise agreement (sometimes referred to as renewal fees).
- **Transfer fees.** These fees compensate the franchisor if and when the franchisee transfers, sells or assigns its rights under the franchise agreement to a third party.

Successor and transfer fees are ordinarily charged as either a:

- Fixed fee.
- Percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee obtains the successor franchise or transfers the franchise to a third party.

Successor and transfer fee amounts are disclosed in Item 6 of the franchisor's FDD.

SERVICE FEES

Depending on the franchise system used, franchisors charge franchisees service fees, including brand building fees, among others, for services provided.

Brand Building Fees

Brand building fees are the most common type of service fees. They are charged by a franchisor for the purpose of creating or increasing brand awareness. These fees have different names, including:

- National advertising fund.
- Marketing fund.
- Brand awareness fund.
- Brand fund.

Regardless of the name, the fee usually works the same way. The franchisee pays the franchisor either or a combination of both a:

- Percentage of the franchisee's gross revenues.
- Flat fee on a weekly or monthly basis.

The franchisor then aggregates all of these payments across the franchise system into a common fund and spends the money in the fund to advertise the franchise system locally, regionally or nationally.

In most cases, the franchisor:

- Does not make any guarantees or promises to its franchisees that it will conduct advertising or brand awareness activities in a way that ensures that each individual franchisee will benefit directly or indirectly from the fund.
- Usually retains complete discretion over how the funds are spent, although some franchise systems use a council of franchisees to help direct advertising.
- Reserves the right to use a specified portion of the money paid into the advertising fund to pay its own internal administrative expenses that relate specifically to its advertising or brand-building activities.

The amount of the required brand building fund payment is disclosed in Item 6 of the franchisor's FDD. The specific ways that the franchisor uses or intends to use the brand building fund are disclosed in Item 11 of the franchisor's FDD.

Other Service Fees

Franchisors also charge a fairly wide variety of other service fees, including those that are related to a specific service that the franchisor requires its franchisees to pay for and use. These fees include:

- Technology fees (used to license proprietary software or technology or to maintain and update a system-wide website).
- Customer relationship management fees (used to manage or administer a system-wide program for customer service).
- Fees paid for the franchisee to attend national meetings or conventions.
- Initial or ongoing training fees.

Other service fees are disclosed in Item 6 of the franchisor's FDD.

EXPENSE REIMBURSEMENT AND COST RECOVERY FEES

Expense reimbursement and cost recovery fees are designed to reimburse the franchisor for expenses and costs that it might incur over the life of the franchise relationship in supporting or focusing on the franchisee. These typically include, for example:

- **Indemnification fees.** The franchisee pays indemnification fees when the franchisor requires the franchisee to hold harmless or indemnify the franchisor for claims relating to the franchisee's operation of the franchised business.
- **Attorneys' fees and costs.** Most franchise agreements have a "loser pays" attorneys' fees provision. A minority of agreements have a non-reciprocal fee provision requiring the franchisee to pay the franchisor's attorneys' fees if the franchisee loses in a dispute.
- **Audit fees.** The franchisor typically reserves the right to audit the franchisee to ensure the franchisee is accurately reporting gross revenue. If the franchisee underreports gross revenue, the franchisor often charges the franchisee for the audit costs.
- **Legal fees and administrative costs.** These are assessed if the franchisee does not timely pay the franchisor amounts owed or breaches another provision of the franchise agreement that requires the franchisor to take administrative action or use legal counsel to provide notice of the breach.
- **Interest and late fees.** These fees are assessed if the franchisee's payments owed to the franchisor are not paid in a timely manner.
- **Management or step-in fees.** In most systems, the franchisor retains the right to step into the franchisee's shoes and temporarily manage, operate or terminate the franchised business if the franchisee:
  - dies;
  - becomes temporarily or permanently incapacitated; or
  - commits a material default that has remained uncured.

  Management or step-in rights typically last for a fixed duration and are charged in a specified dollar amount per day that the franchisor operates the franchised business.
- **Insurance.** The franchisor typically has the right (but not the obligation) to obtain insurance on behalf of its franchisee

Franchisors also charge a fairly wide variety of other service fees, including those that are related to a specific service that the franchisor requires its franchisees to pay for and use.

if the franchisee fails to purchase insurance for itself. The franchisor typically charges a fee to cover its expenses of making these arrangements for the franchisee.

- **Income tax reimbursement.** An increasing number of states are now taking the position that if a franchisor has a franchisee located in the state, the franchisee's presence in the state gives a sufficient economic nexus to charge income taxes to the franchisor based on the income earned from the franchisees in that state. Some franchisors in their franchise agreement retain the right to pass these income taxes to the franchisee, effectively requiring the franchisee to gross-up the amount paid to the franchisor, plus the amount of the income tax, so that the franchisee reimburses the franchisor for payments to the franchisee's home state.

These fees are disclosed in Item 6 of the franchisor's FDD.

FRANCHISE AGREEMENT

To avoid shouldering disproportionate liability, prospective franchisees should carefully scrutinize the franchise agreement's terms and conditions before signing a franchise agreement.

Search Drafting and Negotiating a Franchise Agreement Checklist for key issues to consider when drafting and negotiating a franchise agreement.

TERRITORIAL PROVISIONS

Many franchise agreements grant to the franchisee a protected territory (sometimes known as a protected area, exclusive territory, territory or area of operations). The franchisor often reserves the right to conduct certain types of activities within the territory, such as:

- Selling products or services under the franchisor's trademarks within the territory through alternative channels of distribution (which are methods of sale that are dissimilar to the business being franchised), such as:
  - internet sales;
  - mail order sales; or
  - branded product sales through unaffiliated retailers or wholesalers.
- Operating, directly or through franchisees, franchised units at non-traditional locations, such as:
  - airports;
  - kiosks;
  - food trucks;
  - sport stadiums;
  - military bases;
  - hospitals; or
  - schools.
- Operating, directly or through franchisees, businesses under trademarks other than the marks being franchised that may sell products or services that are similar or dissimilar to the products or services that will be sold by the franchisee.

NON-COMPETE PROVISIONS

Typically limited by geography and time, non-compete provisions prevent the franchisee from continuing to operate a similar business both before and after the franchise relationship ends. Some states have laws that prohibit or restrict the application of non-compete provisions after the termination, transfer or expiration of the franchise agreement.

SUCCESSOR FRANCHISE OR RENEWAL PROVISIONS

If a franchisee wishes to continue the franchise relationship after the end of the first term, the franchisor often requires the franchisee to:

- Sign the franchisor's form of franchise agreement that it is then offering to new franchisees, which may include higher fees and a smaller territory, as well as other provisions that are materially different from those that are in the original franchise agreement.
- Remodel, update or renovate the franchised business.
- Sign a general release of claims that the franchisee may have against the franchisor and its affiliates.
- Demonstrate that the franchisee has been in substantial compliance with the franchise agreement during the original term and that it has not been in default under the franchise agreement more than a set number of times during the original term.
- Demonstrate that the franchisee has the right to continue at the same location under its lease or propose an alternative location.
- Demonstrate that the franchisee continues to meet the franchisor's criteria for franchise operators.
- Pay a successor franchise fee that is charged as either a fixed fee or a percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee obtains the successor franchise.

Some state franchise relationship laws restrict a franchisor's right to refuse to renew the franchise agreement, except under certain enumerated circumstances.

TRANSFER PROVISIONS

When a franchisee wishes to sell the franchised business to a third party, the franchisor often requires:

- The transferee to sign the franchisor's form of franchise agreement that it is then offering to new franchisees, which may include higher fees and a smaller territory, as well as other provisions that are materially different from those that are in the original franchise agreement.
- The transferee to remodel, update or renovate the franchised business.
- The franchisee to sign a general release of claims that the franchisee may have against the franchisor and its affiliates.
- The franchisee to demonstrate that it has been in substantial compliance with the franchise agreement during the original term and that it has not been in default of the agreement more than a set number of times during the original term.

- The transferee to demonstrate that the transferee meets the franchisor's criteria for new franchise operators.
- The franchisee to pay a transfer fee that is charged as either a fixed fee or a percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee transfers the franchise to a third party.

Some state franchise relationship laws restrict a franchisor's right to terminate the franchise agreement under certain enumerated circumstances.

Some state franchise relationship laws restrict a franchisor's right to refuse a franchisee's request to transfer the franchise agreement except under certain enumerated circumstances.

COOPERATIVE ADVERTISING PROVISIONS

These provisions require the franchisee, if it is within a geographic area where an advertising cooperative has been established, to contribute a fixed amount or a percentage of the franchisee's gross sales to the cooperative for the purpose of buying advertising that benefits all of the members of the cooperative.

AUTOMATIC OR IMMEDIATE TERMINATION PROVISIONS

Franchisors often retain the right to terminate the franchise agreement immediately, with or without notice to the franchisee, for certain types of franchise agreement violations. Automatic or immediate termination rights often include the right to terminate the franchise agreement if the franchisee:

- Is insolvent or bankrupt.
- Abandons the franchised business.
- Underreports or otherwise falsely reports income to the franchisor.
- Misuses the franchisor's confidential information, trade secrets or intellectual property.
- Misrepresents facts to the franchisor.
- Makes an unauthorized transfer of the franchised business or its assets.
- Commits any felony or misdemeanor that is likely to reflect materially unfavorably on the franchisor or the franchised business.
- Fails to comply with applicable laws.
- Repeatedly defaults under the franchise agreement, even if the defaults can be cured.
- Violates restrictive covenants.
- Sells products or services that have not been approved for sale by the franchisor.

Some state franchise relationship laws restrict a franchisor's right to terminate the franchise agreement under certain enumerated circumstances.

TERMINATION WITH OPPORTUNITY TO CURE

Franchisors usually have the right to terminate the franchise agreement if the franchisee commits a material default that remains uncured after a specified time, for example where the franchisee fails to:

- Make timely payments to the franchisor, its affiliates or approved suppliers.
- Comply with the franchisor's operations manual or other system standards.

DISPUTE RESOLUTION

Many franchise agreements require the franchisee and franchisor to first attempt to mediate any dispute between them before proceeding to litigation or arbitration. Many, but not all, franchise agreements will require the parties to arbitrate any disputes. Most franchise agreements will likely:

- Except franchisor actions for emergency, injunctive or other provisional relief from any mandatory arbitration or mediation proceedings.
- Contain a forum selection clause requiring any litigation to occur in the franchisor's home city and state.
- Apply the franchisor's home state laws as the franchise agreement's governing laws.
- Include jury trial, punitive damages and class actions waivers.

State franchise relationship laws may limit the application of choice of law or forum selection provisions, permitting the franchisee to litigate or arbitrate in the franchisee's home state, under that state's laws.

ATTORNEYS' FEES PROVISIONS

Most franchise agreements contain provisions for the unsuccessful party to pay the successful party's attorneys' fees after the arbitration or litigation proceedings conclude. A small minority of franchise agreements are non-reciprocal and do not require the franchisor to pay the franchisee's attorneys' fees if the franchisee is the successful party in dispute resolution proceedings.

REQUIRED PURCHASES

Franchisors typically require franchisees to purchase from the franchisor or its approved suppliers all, substantially all or part of the products, inventory, equipment, items or supplies used in or sold by the franchisee in the franchised business. Most franchise agreements also provide a procedure for franchisees to propose alternative suppliers to include on the franchisor's approved suppliers list.